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Eurozone debt crises versus new opportunities for global internet banking collaboration and strategic alliances in the EU and Balkan countries

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Abstract

Today internet banking is an alternative delivery channel developed by using internet to offer banking services. International banking sector started to use the internet not only as an innovative payment method to increase customer convenience, but also as a way to reduce costs and enhance profits.

It is observed that the retail markets have remained essentially national/local and internet banking is gaining wider public acceptance in the EU. Internet banking activities continue to increase in the EU region through the opportunities internet provides for the banking sector as well as its low cost benefits for banks. This paper examines internet banking in the context of the banking sector which has a great importance due to its big effect on the economy of the EU and Balkan countries.

Debt-induced economic austerity is destroying the European banking sector which derives no benefit from the borrowed billions but must now make great sacrifices to bail out. In this study, the potential risk of the Sub-Prime banking crisis into a sovereign debt one in Euro area countries is investigated. Nevertheless, the serious threats, which concern Greece and Italy, do not permit us to exclude the occurrence of contagious sovereign debt crises in Euro area in the future. There will be economic pain if the Greeks continue with the euro and there will be economic pain if the Greeks leave the euro.

Keywords: Internet Banking, The EU, Enlargement Countries, Debt Crises.

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1. Introduction and Literature Review

Internet is having an important impact on people's lives. Nowadays, internet has grown rapidly and there are 327 million fixed internet subscriptions in OECD countries, equivalent to 27% of the total population. Internet banking is predominantly used for basic deposit-based transactions roughly to the same extent as for buying goods and services. A growing number of businesses in the EU countries purchase and sell goods and services via internet and specialized banking services are only a fraction of the total transactions carried out online.

e-Europe is part of the strategy set out by the Lisbon European Council (March 2000) to make the EU the most competitive and dynamic knowledge-based economy with improved employment and social cohesion by 2010. Since innovative activity is capital intensive and tends to require outside financing, we expect radical innovation to be more prevalent in the countries with a relatively more developed financial sector such as internet banking. The question is, why is internet banking so important nowadays? According to Javelin Strategy and Research, 61 million households regularly use internet banking today and 82 million households are expected to do so by 2012. Internet banking attracts a special worldwide attention because of its importance for the financial activities within the daily life of both banks and customers.

The Eurozone crisis and debate over fiscal reform have led many observers to pray for salvation by a modern, European version of Alexander Hamilton. By this, they generally mean someone capable of leading a movement for a robust fiscal union and implementing this vision (See for example McKinnon, 2011). However, true austerity within the European Union would have been disastrous for the German economy, since declines in consumption would have come at the expense of German exports. While demand from Greece is only a small portion of these exports, Greece is a part of the larger system and the proper functioning of that system depends very much on the strategic interests of Germany.

In this regard, the Greeks have two choices concerning the European Debt Crisis. First, they can accept responsibility for the debts on the terms negotiated and accede to the constraints on their budget and tax discretion whether imposed by a commissioner or by a less formal structure. Second, they can default on all debts. Since the European Central Bank already controls the Greek currency, the euro, this would effectively transfer the control of the Greek government to the EU.

In the IMF forecast in September 2011, a growth of 1.1% was projected for the eurozone. The IMF is pointing out that the high pace of the global economic recovery has slowed down. The main source of this stall is no doubt Europe and especially the eurozone. It is predicted that the financial crisis in Europe will lead to a mild recession in 2012. Developments in the euro area also threaten emerging Europe and may spill over to other emerging markets.

The theoretical literature about the subject matter makes some important predictions regarding the ability to predict financial crises correctly. Recent literature has widely examined the potential linkages between a currency and a banking crisis. Empirically, Reinhart and Rogoff (2008 a, b) even portrayed this lack of empirical studies relating banking and debt crises as 'a forgotten story', and proposed a historical analysis beginning in 1900 for a large set of developed and industrialized countries. They reported the proportion of banking and debt crisis episodes for each year. It turns out that financial sector turbulences had consequences for sovereign default crisis, increasing the likelihood of the Sub-Prime crisis to mute into sovereign debt problems (Candelon and Palm, 2010: 83). Another study is that of Demirgüç-Kunt, Detragiache, and Merrouche (2010) who examined banks' stock return performance during the financial crisis, focusing primarily on the effect of different measures of capital and bank governance, respectively.

The average bank stock return from June 30, 2007 to September 30, 2008, the phase of the financial crisis before the beginning of government capital purchase programs, was a poor 31%. The stock return during the recent eurozone debt crisis is also low, i.e. 13%. Indeed, banks with higher risk-weighted assets performed worse during the severe phase of the crisis, from July 2007 to September 2008. We find a similar result when we focus on the ongoing crisis in Europe (Sonali, 2012: 9-18).

Now, we will briefly review the theoretical literature also about internet banking according to the innovative version of the collaboration and strategic alliances in the EU versus some selected enlargement countries. Within the knowledge-based economy, innovation is seen to play a central role, but until recently the complex processes of innovation have been insufficiently understood (Apak, 2007: 327).

Meanwhile, internet has the capability of bringing the same aggressive supply chain management to smaller producers. Less sophisticated than the proprietary systems, internet channel nonetheless offers wider opportunities for cost savings. For example, a small manufacturer, through its web page, can now establish an electronic auction where suppliers can literally bid to supply the intermediate goods they need to produce their products (Wenninger, 1999). DeYoung's 2005 study, on the other hand, analyzes the performance of a dozen pure internet banks that were founded between 1997 and 2001.

This paper attempts to identify which features of the pure online banking model have been effective, why some banks have been able to deploy this model more successfully than others, and whether the internet-only business model could be economically sustainable in the long run. The empirical results confirm the low average level of profits at pure internet banks.

The relevant literature on internet banking may be divided into two groups: on the one hand, some authors focus on internet as an innovative delivery channel representing new challenges to the financial sector. Referring to the first group, Birch and Young (1997) argue that internet may be exploited as a new delivery channel by the financial services industry to completely reorganize the structure of banks. The second group of studies examines the consequences on bank performance of different strategic models of online banking.

In this context, the importance of understanding the causes of the financial crises and predicting them early on is especially true with the EU candidate countries that, as a consequence of the recent global financial and economic crisis, have been forced to deal with multiple exogenous shocks simultaneously. In order to mitigate the severe consequences of the global financial and economic crisis, these countries have turned to international financial institutions asking for a substantial financial aid (Bucevska, 2011: 14).

In what follows, the Eurozone Debt Crises will be discussed and some stylized facts on the evolution of liquidity and leverage across groups of banks will be described in Section 2; Internet Banking in the EU and Enlargement Countries will be examined in Section 3 and the conclusions will be discussed in Section 4.

2. Eurozone Debt Crises

Banking sector in recent decades has not followed the productive lines that early economic futurists expected. Instead of financing tangible investment to expand production and innovation, most loans are made against collateral, with interest to be paid out of what borrowers can make elsewhere. At the same time, solving the Euro zone's financial problem can be made much easier by the tax reforms that classical economists advocated to complement their financial reforms.

Meanwhile, cross-border bank loans particularly when granted by foreign parent banks to their local subsidiaries, while empirically more volatile than other capital flows, are easier to rollover under some circumstances than, for example, sovereign debt.

2.1. Subprime Mortgage Crises

Originally, that was to come only from mortgages held by banks, meaning they would bear the costs. When the crisis broke out, European banks found themselves holding large amounts of poor-quality, inadequately-rated securitized obligations. In this context, the mortgage market has changed drastically over the past half-century in terms of the types of products offered to borrowers.

Over the last decade there have been several innovations in mortgage markets, such as the lowering of payment requirements and the reduction of costs associated with extracting equity from homes (Doms and Krainer, 2007: 21). Despite the considerable media attention given to the collapse of the market for complex structured assets that contain subprime mortgages, there has been too little discussion of why this crisis occurred.

"The Subprime Crisis: Cause, Effect and Consequences" argues that three basic issues are at the root of the problem, the first of which is an odious public policy partnership, spawned in Washington and comprising hundreds of companies, associations and government agencies, to enhance the availability of affordable housing via the use of creative financing techniques.

Second, federal regulators have actively encouraged the rapid growth of over-the-counter (OTC) derivatives and securities by all types of financial institutions. And third, also bearing blame for the Subprime Crisis is the related embrace by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board of fair value accounting (Whalen, 2008: 2).

Banking system with weaker structural liquidity and higher leverage before the global financial crisis was more vulnerable to subsequent failure. At the same time, there is evidence of systematic differences across bank types. The smaller banks were more susceptible to failure on liquidity problems, while the large cross-border banking groups typically failed on insufficient capital buffers. This difference is crucial from the financial stability perspective, and implies that regulatory and supervisory emphasis should be placed on ensuring that the capital buffers of the systemically important banks are commensurate with their risk-taking.

In a new IMF paper, Vazquez and Federico analyze the evolution of bank funding structures in the run up to the global financial crisis and study the implications for financial stability, exploiting a bank-level dataset that covers about 11,000 banks in the U.S. and Europe during the period between 2001 and 2009. The results show that banks with weaker structural liquidity and higher leverage in the pre-crisis period were more likely to fail afterward (Vazquez and Federico, 2012: 16).

2.2. Euro Area and Financial Crisis

The fear of a potential sovereign debt crisis in Euro area will also force European authorities to update the legal framework to address such events, considering that they are, after all, not so rare (Candelon and Palm, 2010: 98). If we take the Euro area into account, the Germans are caught in a dilemma. On the one hand, Germany is the last country in Europe that could afford general austerity in troubled states and the resulting decline in demand.

Moreover, country-specific macroeconomic conditions also played a role in the likelihood of subsequent bank failure, implying that banks failed to properly internalize the associated risks in their individual decision-making processes. Thus, while more intrusive regulations entail efficiency costs, the results point to associated gains in terms of financial stability that have to be pondered. This also supports the introduction of a macro-prudential framework as a complement to traditional, micro prudential approach (Vazquez and Federico, 2012: 18).

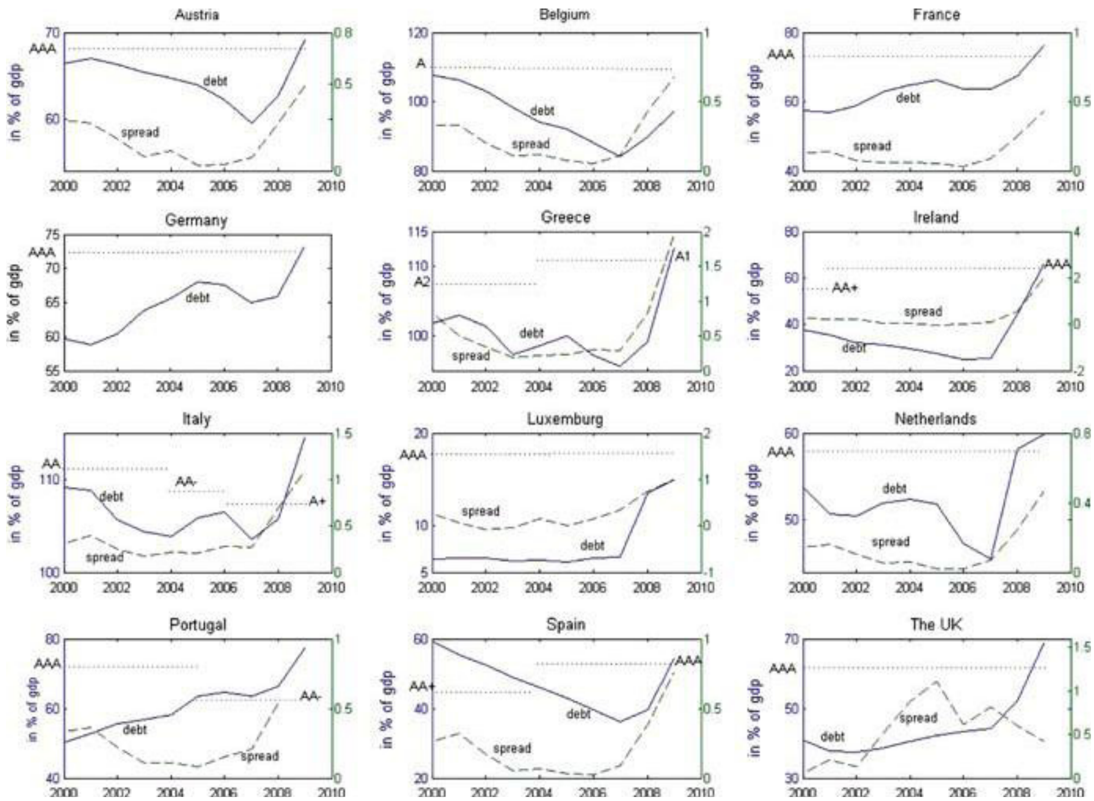


Fig. 1 – Debt-GDP ratio, Government bond spread and sovereign debt ratings in selected EU Countries.
Source: Candelon and Palm, 2010.

On the other hand, it cannot simply tolerate Greek-style indifference to fiscal prudence as it can be seen Fig.1 above. Germany must have a structured solution that to some degree maintains demand in countries such as Spain or Italy; Germans must show there are consequences to not complying with the orderly handling of debt without default. Above all, the Germans must preserve the European Union so they can enjoy a European free-trade zone. There is thus an inherent tension between preserving the system and imposing discipline. In the Euro area, the room for policy discretion is further reduced by the European treaty, prohibiting the European Central Bank (ECB) to lend to member state governments (See.Fig.1) (Candelon and Palm, 2010: 87).

2.3. The EU's Candidate Countries and Financial Crisis

The enlargement countries such as Turkey, Serbia, FYR Macedonia and Croatia are expected to pursue EU-related reforms and to improve the business environment, thereby helping to overcome the economic crisis and to achieve sustainable growth.

After the crash of the US subprime market, rising concerns about the quality of outstanding loans in the Balkan countries have occurred. As the financial crisis spread to Europe, these concerns have materialized. An increase in the share of bad loans led to a slowdown in bank lending. As a consequence, the debt-led growth model was hit by the financial crisis, leading to a sharp drop in GDP growth rates in Bosnia and Herzegovina, Croatia and Serbia (Ćetković, 2011: 4).

Therefore, a defining feature of the impact of the global crisis on the enlargement Balkan (SEE) countries (Albania, Bosnia-Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia) is the absence of a large-scale banking crisis (usually triggered by a large currency depreciation) of the type observed in past episodes of turmoil in emerging market economies. This outcome is even more noteworthy if one considers that banks' balance sheets were highly exposed to currency and credit risks arising from extensive eurozation. When external financial conditions deteriorated, the SEE countries with high external financing requirements found themselves in a very vulnerable position (Cocozza, 2011: 52-57).

According to the above mention explanation, questions have also been raised about the commitment of Western European banks to the Balkan region, but all the large banks in the region have stayed the course. Foreign parent banks dominate the region's banking systems, accounting for 60% to 90% market share, depending on the country.

As an enlargement and candidate country to the EU, Turkey's banking system (nearly one third of measured by assets) has links to parents in peripheral Europe and despite limited direct funding from their foreign parents, availability and cost of funding are likely to reflect to some extent the parents' financial condition. Possible de-leveraging by European banks as they rebuild their capital ratios may further affect Turkish banks' access to wholesale funding. Turkish branches abroad play a smaller role in providing loans to resident firms than in the past, but have become more active in securing external funding (accompanied by an increase in their holdings of government securities) (IMF, 2012: 40).

3. Internet Banking in the EU and Enlargement Countries

In the EU-27, 95% of enterprises had access to internet in 2009. In the enlargement countries for which data are available, enterprises largely had access to internet. In Croatia, the former Yugoslav Republic of Macedonia, Iceland, Serbia and Turkey, over 85% of enterprises had access to internet in the most recent year for which data are available.

Some banking institutions limit their internet banking services to an informational website. Others are using their websites not only to provide the basic operations such as fund transfer or account details, but also to provide new services such as securities trading, bill payments, check book requests, credit card requests and investment advice. In addition, these organizations rushed to provide internet based services in order to gain competitive advantage (Achour and Bensedrine, 2005: 2).

3.1. The Macroeconomics of the Internet Economy

Expected macroeconomic determinants of the innovation can be classified as follows:

- The expenditures of research and development,
- Human capital
- Information and communication technologies
- International competition and market structures
- Financial system supporting small firms
- Innovative and creative culture
- Education
- Property rights and royalty payments
- Government policies
- Technology bases and clusters for firms
- Foreign direct investment
- Other factors (OECD, 2007: 49).

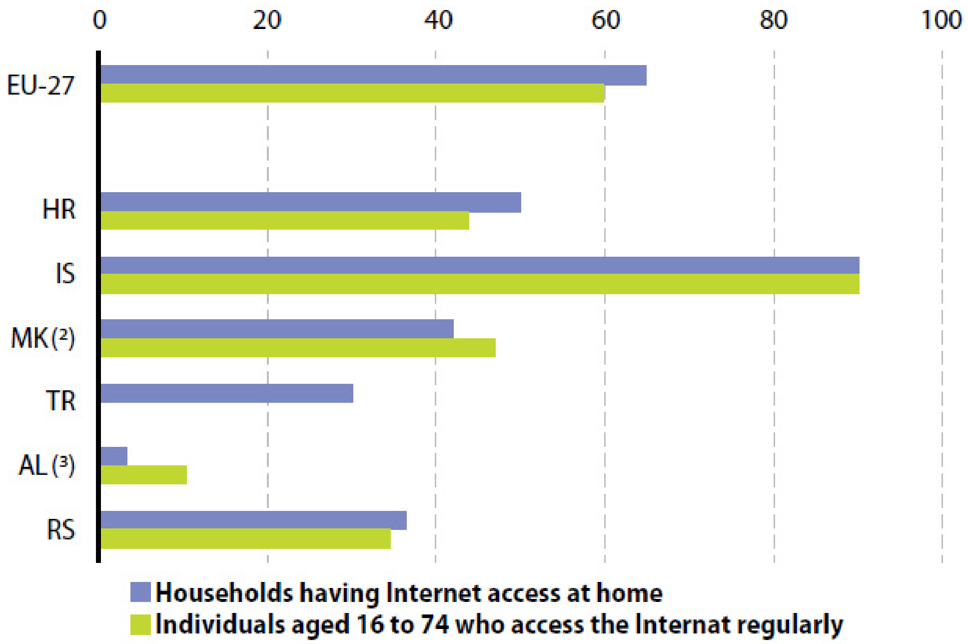
The banking sectors do not yet properly fulfill their financial intermediation role and thus do not yet fully realize their potential for supporting economic growth and macroeconomic stability (Centeno, 2003: 9). Macroeconomic variables have little to no impact. Higher long-term interest rates decrease the return to assets of internet banks without increasing their cost to income ratio. The growth of labor productivity has limited impact on the costs of mixed banks (Arnaboldi and Claeys, 2008: 20).

During the past eight years, the US economy has compiled a remarkable record of noninflationary growth, coupled with rising productivity and low levels of unemployment. As a result of this phenomenal performance, business economists have steadily revised their estimates of the economy's growth potential upward and its presumed NAIRU downward. When pressed for ex post explanations of these persistently better-than-forecasted results, the profession has turned increasingly toward identifying accelerating technological progress as one of the main driving forces. Internet is apparently playing a role in promoting the economy's improved macroeconomic performance (Albert, 1999: 42).

3.2. Internet Banking in the EU and Balkan Countries

According to the Fig.2 below, in the EU-27, 65% of households had access to internet and 60% of individuals accessed internet regularly in 2009. The corresponding figures in Iceland were much higher, 90% for both variables, while Croatia and the former Yugoslav Republic of Macedonia recorded rates ranging between 40% and 50% in 2009. Serbia followed, with the rates for households with internet access and for individuals accessing the internet regularly both at around 35%.

In Turkey, 30% of households had access to internet. In contrast, figures in Albania were much lower, only around 3% of households had access to internet and around 10% of individuals accessed internet regularly in 2008 (Everaers et al., 2011: 131-32).



(¹) Montenegro, Bosnia and Herzegovina and Kosovo under UNSCR 1244/99, not available.
(²) Estimated data.
(³) 2008 data.

Fig.2 Internet Usage by individuals in selected Balkan countries and EU-27
Source: Eurostat, 2010.

In this regard, the fact that the banking systems in the Balkan (SEE) countries are largely owned by a small number of Western European banks was a decisive factor that shaped the ability and incentives of foreign creditors to coordinate (most notably through the so-called "Vienna Initiative") on a rollover of their exposures, thus avoiding potentially dangerous outflows of external financing.

At the same time, it should be recognized that the dominant presence of foreign-owned banks exposes the SEE banking systems to funding risks, in case of problems faced by the parent banks, or contagion risks through the common creditor channel (i.e., risks of contagion from a country-specific shock in the region) (Cocozza, 2011: 7).

Although these risks generally did not materialize during the crisis, the SEE banking systems remain exposed to funding risks in case of problems faced by Western European parent banks of domestic subsidiaries, which might result in a renewed credit contraction (IMF, 2012).

Therefore, internet banking continued its regular growth. The adoption of internet banking depends much on the technological capacity of using online tools. According to Fig.3 below, internet banking is very popular in the Nordic countries and in the Netherlands, where over 75% of individuals use internet for banking in the period between 2009 and 2010 with the exception of Balkan countries such as Romania and Bulgaria, where it remained a rarity in 2010.

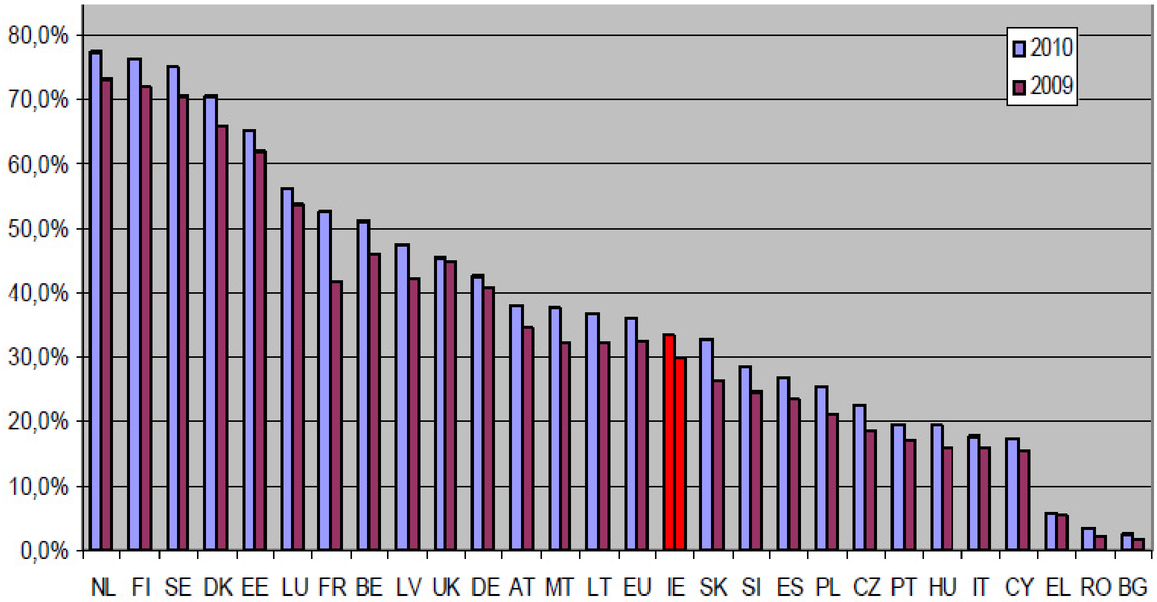


Fig.3 Use of online banking in the EU % of citizens (2009-2010)
Source: Eurostat Community Survey on ICT Usage in Households and by Individuals.

We find that the strategy of banking groups to incorporate internet banks reflects some competitive edge that these banks have in their business models. The management of these banks is generally more capable of handling personnel and other costs. The strategy of banking groups to incorporate internet banks reflects some competitive edge in their business models. Personnel expenses are comparatively low, but the costs for IT are disproportionately high. Management has become more aware of the possibilities of online banking. The success of internet banking depends on the structure of clients' deposits. By focusing mostly on bank deposits, these banks cannot gain benefits from more rewarding banking activities. Clients interested in value added products still prefer interaction with a physical branch. Internet banks need to reach a minimum dimension in order to become profitable (Arnaboldi and Claeys, 2008: 20).

4. Conclusions

The EU and Balkan countries have been seriously hit by the recent financial crisis. In this regard, this study intended to provide a better understanding of the potential mutation of the Sub-Prime turmoil into a sovereign debt crisis in the Euro area and as well as intending to shed some light on the potential linkages between internet banking and current debt crises.

We should expect that the impact of internet banks may not be strong enough to affect the banking system as a whole. However, internet banks certainly contribute to increase transparency on specific products, like current accounts, allowing for comparisons among banks that were previously more difficult (Arnaboldi and Claeys, 2008).

Therefore, if we take into account internet's contribution to the GDP, unfortunately Turkey remains behind. While internet contributes 6.3% of the GDP in a developed country such as Sweden and the world average is 3.4 percent, the rate in Turkey is only 0.9 percent. Turkey is at the bottom among developing countries in terms of internet's contribution to the GDP. Thus Turkey should pay attention to internet's potential contribution to the Turkish economy. Meanwhile, Turkey has a guiding mission to encourage SMEs to open up to the internet banking facilities and increase the effect of internet on Turkey's GDP.

The Balkan countries are still facing a tough road to economic recovery and they will have to reconsider their development strategies for the future. In this context, the prospect of future membership to the EU, if Turkey fulfills the established criteria and conditions, can provide via other Balkan countries a renewed impetus to the reform process. In addition, further work is needed to deepen the understanding of the impact of the macroeconomic environment on financial stability. Finally, it seems that the goal of the so-called Lisbon strategy, i.e. to make the Eurozone the competitive knowledge based-economy in the world by 2010, is far away from reality. The EU must lead the way, and if the EU does not seize its opportunity, instead, the growth potentials will be exploited elsewhere, notably in China and USA.

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